

FEB 28 1991

Assistant Regional Commissioner (Examination) EX:E:2  
Southeast Region

Chief, Branch 6, Office of Assistant  
Chief Counsel (Passthroughs & Special Industries) CC:P&SI:6

Effect of the Morrison Case on ACRS/MACRS, and related matters

This is in response to your memorandum to the Assistant Commissioner (Examination) dated September 10, 1990, regarding a July 31, 1990, memorandum from the Atlanta District Office. Copies of these memoranda are attached. Essentially, the Atlanta memorandum inquires as to the Service's position with respect to structural component depreciation in light of Morrison Inc., v. Commissioner, 891 F.2d 857 (11th Cir. 1990), and the cases that preceded it. These cases include Scott Paper Co. v. Commissioner, 74 T.C. 137 (1980); A.C. Monk & Co. v. United States, 686 F.2d 1058 (4th Cir. 1982); Illinois Cereal Mills Inc., v. Commissioner, 789 F.2d 1234 (7th Cir.), cert denied, 479 U.S. 995 (1986); Piggy Wiggy Southern Inc., v. Commissioner, 803 F.2d 1572 (11th Cir. 1986); and Albertson's Inc., v. Commissioner, T.C. Memo 1988-582 (1988).

We agree with the Atlanta memorandum's observation that the structural component issue has not disappeared with the expiration of the investment credit. The classification of property as personal or real for depreciation purposes is closely related to the investment credit rules. The court in Albertson's notes that additional recovery deductions under section 168 of the Internal Revenue Code will be available if the taxpayer prevails on the investment credit issue. Thus, even though the cases cited above deal with the investment credit, their conclusions will greatly influence property classification for depreciation purposes.

While the structural component issue has always existed in the depreciation context, the much longer recovery periods for real property under MACRS have encouraged taxpayers to classify structural components as personal property. We are not surprised that agents are uncertain how to proceed with their examinations in light of Morrison and the cited cases. We agree with the memorandum's observation that the Tax Court in Morrison applied its own rationale inconsistently.

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The structural components at issue in the cases cited above were generally electrical systems and heating and air conditioning systems (HVAC). With respect to electrical systems, we are presently considering a proposed Revised Action on Decision prepared by the Assistant Chief Counsel (Tax Litigation) for the Illinois Cereal case. The revised AOD was prepared in response to the adverse decision in Morrison. In Morrison, the Service attempted to apply the "adaptable to other operations" test used by the 4th Circuit in Monk. The 11th Circuit specifically rejected this approach and accepted the Tax Court's "functional allocation" method originally set forth in Scott Paper. This method had also been applied, and the Monk approach rejected, by the 7th Circuit in Illinois Cereal.

The government's petition for certiorari in Illinois Cereal was denied by the Supreme court. In view of this denial, and the 11th and 7th Circuits' rejection of Monk in favor of the Tax Court's functional allocation method, the draft of the revised AOD recommends that the Service not challenge the use of the functional allocation method by taxpayers. While a final decision on this matter has not yet been made, we believe that the recommendation of the revised AOD will be adopted.

The HVAC issue was considered in the Piggy Wiggly and Albertson's cases. In these cases the Service argued that all components of HVAC systems are structural components unless the "sole justification" test of section 1.48-1(a)(2) of the regulations is satisfied. In rejecting the Service's arguments, the Tax Court and the 11th Circuit applied a primary purpose standard to the sole justification test. We continue to believe our position in these cases is correct and we do not accept the court's primary purpose approach. At the present time Tax Litigation is preparing to appeal Albertson's. We are hoping for a result that will disagree with the 11th Circuit so as to establish an inter-circuit conflict that will be appealable to the Supreme Court.

As the Atlanta memorandum points out, the Service did not appeal the Tax Court's decisions regarding several other component systems in Morrison. The failure to appeal does not mean that the Service accepts the court's conclusions regarding these systems. The Service's position regarding these systems has not changed. Instead, the Service and the Justice Department made a tactical decision to focus the 11th Circuit's attention on the electrical system, which was the major issue. The other issues raised in the Tax Court should continue to be raised by examining agents.

As indicated by the preceeding discussion, structural component depreciation is presently in a state of flux. This memorandum reflects the current views of the Service regarding the various component systems discussed. We hope this memorandum has been responsive to your inquiry. If we may be of further assistance in this matter, please call Mark Pitzer at FTS 566-3292.

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CHARLES B. RAMSEY

Attachments:  
As stated

cc: Bettie Ricca  
Ken Jones

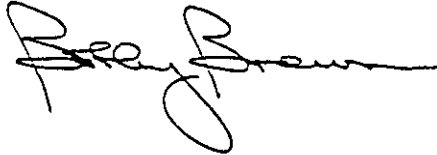
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Internal Revenue Service  
memorandum

date: SEP 10 1990

to: Assistant Commissioner (Examination) EX:C:N  
National Office

for  
from: ARC (Examination) EX:E:2  
Southeast Region



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Subject: Effect of the Morrison Case on ACRS/MACRS, and Related matters

Attached is a memorandum from the Chief, Examination Division, Atlanta District, dated August 3, 1990. The memorandum concerns the confusion surrounding the Internal Revenue Service's position regarding the classification of Section 38/1245, property for tax purposes and the recent court decisions in this area. This presents a severe tax administration problem for field personnel. If field personnel are to continue raising and proposing issues in this area, we will need authority which considers the latest court cases. Should we cease raising and proposing issues in this area, we need to know the authority.

If you have any questions, please contact me at FTS 841-6805, or have a member of your staff contact Charlie Brantley at FTS 841-0007.

Attachment - as stated

RECEIVED

SEP 10 1990  
Chief, National Programs Section  
Room 2142 EX:C:N

# Internal Revenue Service memorandum

date: July 31, 1990

to: Mason Murphy, Manager, Group 1234  
Atlanta District Office

from: Ronald W. Ridgway, Engineer, Group 1234  
Atlanta District Office

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subject: Effect of *Morrison* Case on ACRS/MACRS, and Related Matters.

Cite: *Morrison, Incorporated, et al., Petitioners-Appellees, Cross Appellants v. Commissioner of Internal Revenue, Respondent-Appellant, Cross-Appellee*, U. S. Court of Appeals, 11th Circuit; 88-8665, 1/9/90; Aff'g Tax Court, T.C.Memo. 1986-129.

Just this week, still another person asked me what we engineers are going to be working on now that investment credit is gone. I cannot believe how many IRS people (including those who should know better) seem to be ignorant of the fact that most of the difficult and recurring problems that we used to have with investment credit are still present because of the depreciation impact.

Without going into minute detail, such as citing all relevant cases, code sections, regulations and rulings, I would like to urge that we try to publicize and emphasize the significance of a continuing depreciation issue which many people - even experienced professionals who are familiar with this general topic - either never knew about, or believe expired, with the repeal of investment tax credit at the end of 1985. This issue area involves the classification by taxpayers of certain portions of building construction projects into section 38/1245 property accounts, for depreciation purposes.

In addition, I would like to suggest that the *Morrison* case completes the setting of precedent for future depreciation (cost recovery) deductions based on the classification of all, or allocated portions of, various components or systems of depreciable buildings, as 5-year, section 1245 property, (or as 7-year property under MACRS, after 12-31-86) on a scale which will far exceed what we have experienced previously. The definitions of section 38 property (investment credit property) and section 1245 property are very similar. There have been times since the early 1960's when the definitions were basically identical. Slight changes over the years have altered the definitions slightly, so that there are some minor differences now, but these are not relevant to the point of this memorandum.

As you are keenly aware, for many years taxpayers and their consultants made studies of building construction projects and carved out costs of components which they claimed were qualified as tangible personal property for investment credit purposes. The IRS had countless disputes with taxpayers over this issue during the years prior to 1986. A major dispute arose with the accounting firm Ernst & Whinney over work they did for their clients in this area. A less publicized corollary issue to the investment credit issue was the depreciation aspect which existed due to the fact that section 38 property in most instances was also section 1245 property, which was subject to a shorter useful life or recovery period than section 1250 property.

During the years immediately after ACRS began, in the normal case involving a carve-out of section 38/1245 property, the section 1245 property would have a 5-year recovery period, and the residual section 1250 property would have a 15-year recovery period. The straight line method would have applied to both categories under ACRS. The exact dates are not critical for the purpose of this discussion, but the recovery period for the section 1250 property under ACRS later was revised from 15 years - first to 18 years, then to 19 years, then under MACRS to 31.5 years for non-residential real

property or 27.5 years for residential rental property, after 12-31-86. Also, under MACRS, a new 7-year category was added which would include any section 1245 property for which no class life had been assigned. Moreover, after 12-31-86 under MACRS, for section 1245 property in either the 5-year or 7-year category, the double declining balance method was permitted. It is obvious that the tax advantages (from a time-value-of-money point of view) of 5-year, or 7-year, double declining balance versus 31.5-year straight line cost recovery (depreciation) are quite significant.

Most of our issues or disputes with taxpayers and their consultants, in the later years of the investment credit era, have been over building components. With the expiration of the investment credit at 12-31-85, (except for the transitional rules for binding contracts) many people thought that this controversial area would soon drift away with the passage of time and the progression of our audit cycles into the post-1985 tax years. Even engineers in the field and in the national office, not to mention accountants, attorneys, and others, have voiced this preconception. After all, proposed regulation 1.168-2(e)(1) denies component depreciation on building components, does it not? In addition to the fact that these proposed regulations have never become final, the prohibition contained therein against component depreciation for building components only applies to building components which are "structural components" as defined in regulation 1.48-1(e)(2). Such components are also section 1250 property.

The issue of which elements of the construction cost of a building project are section 1245 rather than section 1250 property is as important to taxpayers today under MACRS (without the investment credit) as it was in 1983 under ACRS (with the investment credit). This is due to the compound effect of two factors. One is the current potential downward shift in useful life from 31.5 years to 7 years, or possibly even to 5 years, compared to the 1983 potential shift in useful life which was merely from 15 to 5 years. The other factor is the potential shift from the straight line method to the double declining balance method of computing depreciation.

I have determined from observation, and from asking corporate tax managers, that most taxpayers (or their consultants) are still making substantially the same studies that they made during the ITC years, even though the motivation is merely the depreciation advantage. The issues today, in spite of the popular notion to the contrary, are just as prevalent and just as significant as before. And, due to recent litigation, they are about to become even more challenging.

As you know, we have lost *Piggly-Wiggly* and *Albertson's* on HVAC in retail stores. The courts in those cases found that qualification for ITC was justified solely based on requirements for operation of equipment. We continue to disagree with those decisions, but we still lost the cases. We won *A. C. Monk* on electrical components and allocation of primary electrical system costs. On the negative side, we have lost *Scott Paper*, *Illinois Cereal Mills*, and now recently, *Morrison*, on essentially the same electrical system issues that we won in *A. C. Monk*.

Moreover, on the issues of the permanently installed kitchen water piping system and kitchen drainage system, which were not even appealed by the government in *Morrison*, even though operating a cafeteria was held to be a retail activity, and not a "qualifying activity" as described in section 48(a)(1)(B) of the code, the Tax Court allowed ITC on both of these systems because it concluded that they did not relate to the overall operation or maintenance of the buildings. The Tax Court held that the kitchen water piping system was necessary to, and was used directly with specific pieces of petitioners' equipment. The Tax Court further held that the kitchen drainage system did not relate to the general drainage of waste from the building but rather, drained wastes resulting from petitioners' food preparation activities. The Tax Court concluded that, despite the apparent character of the kitchen drainage as a permanent plumbing fixture, it actually serviced the petitioners' equipment and machinery and was thus eligible for the credit under the criteria of Rev. Rul. 66-299, 1966-2 C.B. 299. The Tax Court also placed considerable reliance on the *Duaine* case (T.C.Memo 1985-39).

The most immediately telling illustration of the confusion which the rationale of *Morrison* introduces is by a comparison of the Court's descriptions and opinions on the foregoing two systems with its

description and opinion on the kitchen hand sinks. These kitchen hand sinks were held not to qualify, and to be structural building components, largely because they were permanently connected to the kitchen water piping and drainage systems, which did qualify. In other words, the kitchen hand sinks were part of the non-qualified building plumbing system even though their water supply and drainage systems were not.

The Tax Court in *Morrison*, citing *Scott Paper*, stated that "items occurring in unusual circumstances that do not relate to the operation or maintenance of the building should not be considered as structural components even though specifically listed as such in section 1.48-1(e)(2) of the Income Tax Regulations." The gist of the Tax Court's thinking in this regard appears to be that, if the item in question is not one which would be found in almost any building, regardless of the particular design and use of the building under consideration, and especially if it is used directly with equipment or in connection with the activity for which the building was designed, it will not be considered as related to the operation or maintenance of the building. It appears that the Tax Court believes that, to be considered a structural component, an item must be one that would virtually always be needed, or at least useful, for the operation or maintenance of any building, regardless of its present or future use.

Even here, however, the Tax Court is inconsistent, as its analyses and conclusions with regard to several components will reveal, particularly those with regard to the non-qualified kitchen sanitary wall and floor tiles, kitchen hand sinks, serving line concrete curb, and vanity cabinets and counters - on the one hand - versus the qualified customer line screen, emergency lighting, kitchen water piping, and kitchen drainage - on the other hand. *Morrison* is a difficult case for us to deal with, and not just because of the allocation of the cost of the electrical components and primary electrical system.

An attorney in Chief Counsel's Office who specializes in the ITC and related areas of the Code has recently told another IRS engineer in another region that it is extremely unlikely that the Service would choose to litigate this primary electrical system allocation issue again considering that the Supreme Court denied Cert. in *Illinois Cereal Mills*, and that we have lost 3 out of 4 cases, including all of the Tax Court cases. It is more likely that we will acquiesce in *Illinois Cereal Mills*, and decline to respond at all to *Morrison*. This would mean that none of the other confusion and inconsistency of *Morrison* would be dealt with - except by us here in the field, on a catch-as-catch-can basis.

We, here in the field, have a continuing problem of tax administration in this area in spite of the generally held belief that, because the investment credit has expired, the problem is almost behind us. We still have most of the same problems of definition of section 1245/38 property that we have had for years, because of the depreciation factor. The big difference (in my opinion) is that now we are just before being inundated with new tax returns, amended tax returns, claims for refund, and affirmative adjustments during audits in process, alleging that the 5-year, or 7-year, recovery property category should include allocable portions of all electrical systems, plumbing systems, HVAC systems, and many other systems and components of buildings as well. In some cases the entire costs of the systems or components will be claimed as 5-year, or 7-year, recovery property, rather than merely some allocable portion as determined based on some percentage of use, or load, or function.

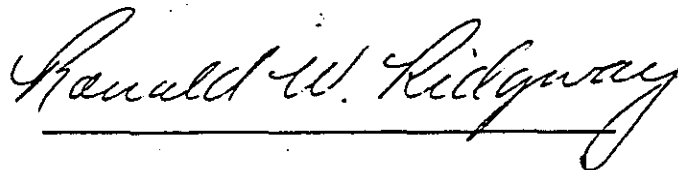
Inasmuch as this severe tax administration problem is obviously going to be a continuing one, then Congress, or at least Treasury Department or Internal Revenue Service officials at the policy making level, should be made aware of it. If they choose to let it continue, then at least it should be done with the knowledge that the situation exists rather than without that knowledge. In any event, we here in the field need to be informed, as soon as possible, what the position of the Service will be on these issues. If we are to continue raising and proposing these issues, we need to have fresh authority which considers the latest cases. We will also probably need to increase or redirect our workforce in order to handle the additional workload. If we are to cease raising these issues, we need to know by what authority. The established, published, position of the Service - such as it is - does not reflect the impact of the most recent cases nor the unpublished, informal, position of certain informed individuals in the Service.

Another important consideration which has not yet been mentioned in this memorandum is the continuing administrative cost to taxpayers who are only trying to determine their correct tax liability under the law. The law in this area (section 38/1245 vs. nonsection 38/1250 property definitions) has forced unnatural, artificial, distinctions to be made between, or allocations to be made of, generally accepted construction categories or divisions used in building construction cost estimating, bidding, sub-contracting, and cost accounting.

This has meant that extra record keeping was required, and, in most cases, it has meant that special cost estimating studies were also required, either by staff personnel, or by outside consultants, in order to determine the taxpayers' version of the correct classifications of cost, under their interpretation of this very complex body of income tax law. Making the study is only the beginning in many cases. If the IRS audits this item, there will be audit support expenses associated with the defense of the taxpayers' claims, including accounting, legal and other costs, perhaps even through the Courts. For almost thirty years now, this administrative cost or burden has plagued taxpayers who were only trying to determine - to the best of their ability - their correct tax liability. It has also been a considerable expense to taxpayers who were trying to take every advantage they could of our tax system, and of the innate difficulty we have in administering this complex body of income tax law, in an effort to minimize their tax liability to the maximum extent possible.

This is a problem area which seemingly will just not go away. Taxpayers and the Service have the same basic problem, except that their version may be worse than ours. If the repeal of the investment credit as of the end of 1985 was intended to solve the problem, it has not succeeded. Recent litigation in this area, including the *Morrison case*, has helped in some definitional areas, but has exacerbated the situation in others.

From the point of view of engineers and agents who are having to deal with these issues during ongoing examinations, this is a matter which should be treated with some urgency. On behalf of all of us, and for the good of the Service in trying to carry out its mission, I recommend that you use whatever influence you have to bring this matter to the attention of IRS management, in the hope that some action might be taken, and some relief granted, in the near future.



Ronald W. Ridgway, P.E.